

Letter of Findings 02-20200419
Corporate Income Tax
For the Years 2015, 2016, and 2017

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

The Department agreed with Clothing Retailer that - in reviewing Clothing Retailer's Indiana corporate tax returns - the Department erred in adjusting Clothing Retailer's federal adjusted gross income and its originally reported inter-company interest expenses.

ISSUES

I. Indiana Corporate Income Tax - Federal Income Adjustment.

Authority: IC § 6-8.1-5-1; *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that the Department erred in adjusting its federal taxable income.

II. Indiana Corporate Income Tax - Calculating Intangible Interest Expenses.

Authority: IC § 6-8.1-5-1; *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010).

Taxpayer disagrees with the Department's decision adjusting its intangible interest expense deductions.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of selling clothing and related items. Taxpayer sells goods to its customers over the Internet and in brick-and-mortar stores. Taxpayer conducts business in Indiana and other states.

On its federal consolidated income tax return, Taxpayer is listed as the parent on the affiliated group of businesses.

The Indiana Department of Revenue (Department) conducted an audit review of Taxpayer's income tax returns and its related business records. The audit resulted in an assessment of additional Indiana corporate income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted by video conference during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Indiana Corporate Income Tax - Federal Income Adjustment.

DISCUSSION

The issue is whether Taxpayer has met its burden of proof necessary to establish that the Department's adjustment of its reported federal income was wrong. In particular, Taxpayer challenges the Department's decision increasing Taxpayer's reported 2016 federal taxable income by approximately \$6,000,000. That decision resulted in an additional assessment of approximately \$8,000.

The Department's audit report explained that "Taxpayer reported federal taxable income in error due to three errors in the computation of intercompany interest expense." According to that same report, Taxpayer explained these "errors" as follows:

"Model Adjustments" were made to the loan balances that changed intercompany interest expense. These were clean-up entries made in preparation to the new Oracle accounting system.

The audit concluded that "[f]or IRS purposes, corrections of errors for these model adjustments are treated as prior period adjustments that are recognized as revenue in the current period."

The audit pointed to adjustments which reduced loan balances owed by Taxpayer affiliates or corrected for errors in calculating compound interest.

Taxpayer explains the calculation is misguided because the \$6,000,000 "of intercompany interest was already reported as a reduction to interest expense on the originally filed federal return." Although Taxpayer agrees the amount of \$6,000,000 should be included in federal taxable income it "did so on the originally filed federal tax return." According to Taxpayer, "The final audit report results in [\$6,000,000] being reported as income twice."

In seeking to correct the purported error, it is Taxpayer's responsibility to establish that the assessment of additional tax, and the original audit report's conclusions regarding the interest expenses, were "wrong."

As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department bears in mind that "when [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within the audit and this Letter of Findings are entitled to deference.

A review of Taxpayer's returns, the audit report, and the explanation provided by Taxpayer supports its explanation. The \$6,000,000 was correctly accounted for in Taxpayer's original return. Any Department adjustment to the contrary was in error.

FINDING

Taxpayer's protest is sustained.

II. Indiana Corporate Income Tax - Calculating Intangible Interest Expenses.

DISCUSSION

Taxpayer next argues that the Department erred in disallowing interest expenses claimed on Taxpayer's original return.

Taxpayer explains. During 2016, Taxpayer reported an intangible expense adjustment on its original return. On that return, Taxpayer reported approximately \$42,000,000 in interest expenses paid to a related company.

A. Taxpayer's \$6,000,000 Interest Expense Error.

In preparing for the Department's audit, Taxpayer determined it had made an error in reporting the interest expenses. Instead of \$42,000,000 the amount of interest expense claimed on the return was overstated by approximately \$6,000,000. With that in mind, Taxpayer concludes that the interest expenses should have been approximately \$36,000,000.

What is the significance of Taxpayer's claim that it originally overstated the amount of intercompany interest claimed on its federal return? The Department's audit cited to IC § 6-3-1-3.5(b) which provides that, in determining *Indiana* corporate adjusted gross income, Taxpayer must addback certain expenses claimed on the federal return as follows:

In the case of corporations, [Indiana adjusted gross income is] the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

....

Add to the extent required by [IC 6-3-2-20](#):

(A) the amount of intangible expenses (as defined in [IC 6-3-2-20](#)) for the taxable year that reduced the corporation's taxable income (as defined in Section 63 of the Internal Revenue Code) for federal income tax purposes; and

(B) any directly related interest expenses (as defined in [IC 6-3-2-20](#)) that reduced the corporation's adjusted gross income (determined without regard to this subdivision). For purposes of this clause, any directly related interest expense that constitutes business interest within the meaning of Section 163(j) of the Internal Revenue Code shall be considered to have reduced the taxpayer's federal taxable income only in the first taxable year in which the deduction otherwise would have been allowable under Section 163 of the Internal Revenue Code if the limitation under Section 163(j)(1) of the Internal Revenue Code did not exist.

If a business claimed intercompany interest expenses on its federal corporate income tax return, those expenses are added back to calculate *Indiana* adjusted gross income.

Taxpayer claims the Department has it wrong because the "increase to the intangible interest expense adjustment made by the Department of Revenue does not reflect the amounts paid in calculation of its federal taxable income."

As noted above, it is Taxpayer's statutory responsibility under IC § 6-8.1-5-1(c) to establish that the assessment was wrong, and that Taxpayer must present clear and cogent evidence supporting that position. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In this instance, Taxpayer is again correct. The intercompany interest expenses were correctly accounted for in Taxpayer's original return. Any Department adjustment to the contrary was in error.

B. \$18,000,000 in 2016 Intangible Interest Expenses.

The Department's audit found that Taxpayer had failed to addback approximately \$18,000,000 in 2016 interest expenses. As explained in the audit report:

The audit determined that the Taxpayer correctly added-back interest expenses paid to [related companies] for the period 1/30/2015 in the amount of [approximately \$18,000,000] because it does not meet the exception to the addback under IC § 6-3-2-20(c). However, no add-back was made for the periods 1/29/2016 - 1/27/2017 for [related companies] per the Taxpayer's loan schedules is [approximately \$24,000,000] respectfully.

Taxpayer states that its "loan schedules do not support the [approximately \$18,000,000] reference by the Department of Revenue." Taxpayer concludes that the expense should be changed to reflect the original draft audit report which - according to Taxpayer - was "originally agreed to by the [T]axpayer."

There is little in the audit report which ticks-and-ties the \$18,000,000 adjustment described in the narrative to the supporting documentation. However, other than the argument that Taxpayer preferred the results of the preliminary draft audit report, there is nothing substantive which supports Taxpayer's argument that the adjustment was "wrong." Taxpayer has not met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the adjustment described here was wrong.

FINDING

Taxpayer's protest is sustained in part and denied in part. Taxpayer has met its burden of establishing that it

originally overstated the amount of intangible interest expenses by approximately \$6,000,000; Taxpayer has not met its burden of establishing that the audit erroneously adjusted the 2016 interest expense amount.

SUMMARY

Taxpayer is sustained on Issue I above regarding adjustments for intercompany expenses. Taxpayer is sustained on Issue II above regarding intangible interest expenses. Taxpayer is denied on Issue II above regarding 2016 interest expenses.

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